The Commonwealth of Massachusetts

DEPARTMENT OF PUBLIC UTILITIES

D.P.U. 07-89 April 30, 2008

Petition of Bay State Gas Company for a change in tariffs under a performance-based rate plan including the following tariffs: M.D.P.U. Nos. 69 through 94, and canceling M.D.T.E. Nos. 37 and 38-B through 62-B, filed with the Department on October 17, 2007.

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I. INTRODUCTION AND PROCEDURAL HISTORY

On October 17, 2007, Bay State Gas Company ("Bay State" or "Company") filed a petition with the Department of Public Utilities ("Department") seeking approval of new tariffs: M.D.P.U. No. 69 through 94. The tariffs are designed to recover the following: (1) the level of revenues approved in Bay State's last general rate case, Bay State Gas Company, D.T.E. 05-27 (2005), associated with a drop in average use per customer; and (2) costs of investments made pursuant to its ongoing steel infrastructure replacement program ("SIR"). The Company filed the petition pursuant to D.T.E. 05-27, at 400, which makes a specific provision for companies operating under a performance-based rate plan ("PBR"):

> [C]ompanies retain the option to petition the Department for changes in tariffed rates in reaction to extraordinary economic conditions.

The Department docketed this matter as D.P.U. 07-89 and suspended all tariffs accompanying the petition for further investigation until May 1, 2008. Pursuant to notice duly issued, the Department held public hearings as follows: on November 27, 2007 in Brockton; on November 29, 2007 in Andover; and, on December 4, 2007, in Ludlow. The Attorney General of the Commonwealth of Massachusetts ("Attorney General") intervened pursuant to G.L. c. 12, § 11E. The Department also granted the petitions to intervene of the Massachusetts Division of Energy Resources, the New England Gas Workers' Association ("NEGWA"), and KeySpan Energy Delivery New England. Further, the Department granted limited participant status to NSTAR Electric Company and NSTAR Gas Company.

On February 29, March 11, and March 12, 2008, the Department held evidentiary hearings. In support of its proposal, the Company sponsored the testimony of Danny G. Cote, general manager of Bay State; Joseph Ferro, manager of Bay State's regulatory policy; and, Lawrence R. Kaufmann, partner at Pacific Economics Group, L.L.C. The Attorney General sponsored the testimony of Timothy Newhard, financial analyst in the Utilities Division of the Attorney General and Lee Smith, principal, LaCapra Associates. The evidentiary record includes approximately 370 exhibits, and 34 responses to record requests. The Company, the Attorney General, and NEGWA submitted briefs on March 18, 2008 ("Company Brief," "Attorney General Brief," and "NEGWA Brief," respectively). The Company and the Attorney General submitted reply briefs on March 25, 2008 ("Company Reply Brief" and "Attorney General Reply Brief," respectively).

II. BACKGROUND

Bay State provides retail natural gas service to approximately 285,000 customers in three non-contiguous divisions identified by their major cities (i.e., Springfield, Brockton and Lawrence). Bay State is a wholly-owned subsidiary of NiSource Inc. ("NiSource"), which is a registered public utility holding company located in Merrillville, Indiana. NiSource Corporate Services Company, Inc. is a subsidiary of NiSource that centralizes and provides professional and managerial services to the NiSource operating companies, including Bay State.

Pursuant to D.T.E. 05-27, Bay State operates under a ten-year PBR, which began on December 1, 2005. That rate plan provides for annual adjustments according to the price index[1] and earnings sharing.[2] Id. at 361. The PBR also provides for a mid-term review in

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1 Bay State's annual PBR adjustments are determined by applying a price cap index ("PCI") to the Company's then-current distribution rates under the following formula:
(continued...)

2010 of the Company's PBR and the SIR expenditures, if the Company's return on equity ("ROE") is below six percent. Id. at 49-50, 400. These components of the PBR were designed by the Department to mitigate risks that shareholders and ratepayers may face as a result of a ten-year plan. Id. at 398-401.

Bay State has made two annual compliance filings under the PBR. On September 16, 2006, Bay State filed its first annual PBR compliance filing. D.T.E. 06-77 (2006). The Company requested and the Department allowed a $3,586,673 rate increase. Id. at 10. In addition to the base distribution rate adjustment, "the Company also proposed to collect an exogenous cost related to a decrease in the average use per customer." Id. at 5. In rejecting the Company's adjustment for declining average use per customer ("AUPC"), the Department

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[1](...continued)

$$PCI_{new} = PCI_{current} * (1 + P - X \pm Z)$$

where P is a factor that represents inflation,
X is a factor that represents a productivity offset factor, and
Z is a factor that includes costs associated with exogenous factors; i.e., those cost factors that are considered beyond the control of the Company, that affect the Company's unit cost but are not accounted for in the inflation component.

This price cap index type plan is commonly referred to as the PBR adjustment. Bay State Gas Company, D.T.E. 05-27, at 361 (2005).

[2] The earning sharing mechanism of Bay State's PBR provides for a deadband of 400 basis points around the Company's authorized return on equity ("ROE") of ten percent. If Bay State's actual ROE is 400 basis points or more below the authorized ROE, 75 percent of the loss would be borne by shareholders and 25 percent of the loss would be borne by ratepayers. Conversely, if the Company's ROE exceeds its authorized ROE by 400 basis points or more, then 75 percent of the gain would accrue to shareholders and 25 percent to ratepayers. Bay State Gas Company, D.T.E. 05-27, at 401 (2005).

noted that declining AUPC is a 25-year trend and was not an unforeseen or unique event. Id. at 13. Commenting on the Company's "financial integrity," the Department noted "that the PBR mechanism contains provisions that allow for recovery in the event that a significant drop in revenues occurs, such as the earnings sharing mechanism." Id. at 14.

On September 14, 2007, Bay State made its second annual compliance filing. D.P.U. 07-74 (2007). After review by the Department, the Company received a PBR adjustment of $5,882,030, including an earnings sharing adjustment of $2,590,693, on October 31, 2007. Id. at 4. In addition, in Bay State's peak period 2007-2008 Cost of Gas Adjustment filing, D.P.U. 07-GAF-P1 (2007), the Company received $2,992,550 in Margin Sharing and $748,859 through the pension and post-retirement benefits other than pension ("pension/PBOP") reconciliation mechanism.[3]

III. COMPANY'S PROPOSAL

A. Poor Financial Condition of Bay State

Bay State characterizes its financial condition as very poor (Exh. BSG/JAF-1 at 4). In support of this characterization, the Company relies on its ROE calculations for 2006.[4] The Company states that its booked return on equity ("ROE") for 2006 was 4.06 percent, and 5.71 percent after normalizing for weather (RR-DPU-7). The Company states that this ROE

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3 See Bay State filing in D.P.U. 07-GAF-P1, § 5, Form III, Sch. 7, col.7, ln. 13 for margin sharing adjustment and §11, at 1, Col. 3, ln. 9+ ln. 10+ln. 11.

4 Throughout this proceeding, various ROE calculations have been provided (RR-DPU-7; RR-DPU-12; RR-DPU-20). For the purposes of this Order, the Department accepts the ROE calculations provided in RR-DPU-7 that excludes Bay State's Acquisition Premium and related deferred income taxes.

level threatens the Company's ability to continue providing safe and reliable natural gas distribution service (Company Reply Brief at 5, citing Exh. BSG/LRK-1, at 23). Bay State projects that without its requested relief, the Company's ROE will never exceed eight percent during the remaining years of its PBR and will decline to four percent by 2014, even when factoring in all other adjustments allowed by the PBR (Company Reply Brief at 3, citing RR-DPU-20; see also Tr. at 266, 291-2).

As additional support for characterizing its financial condition as poor, the Company lists its recent history of not distributing dividends in 2006 and 2007 (Company Reply Brief at 2, citing RR-DPU-6). The Company also cites the bond ratings of its parent company, NiSource: three rating agencies list NiSource at the lowest grade of investment grade bond ratings, just above speculative (Company Brief at 1-2). In December, 2007, Standard & Poor's ("S&P") downgraded NiSource's bond rating to BBB-, the lowest of investment grade bond ratings, which Bay State claims was due to declining AUPC and infrastructure investment (id.).

B. Cause of Financial Condition

Bay State claims its poor financial condition is caused by its inability to collect the level of revenues allowed by D.T.E. 05-27 due to a decline in AUPC that has taken place since the 2004 test year used in D.T.E. 05-27 as well as the SIR expenditures (id. at 2). The Company specifically notes that from 2004 through 2006, the AUPC has declined 8.7 percent (weather-normalized) for residential customer classes and 8.3 percent (weather-normalized) for small commercial classes (id. at 22).[5] Further, the Company expects that its poor financial condition will continue to deteriorate over the term of the PBR because the PBR mechanism does not adjust base rates to reflect declining revenues caused by a decline in AUPC from test year levels on which cast-off rates are established, nor does it adjust for significant incremental investments in non-revenue producing plant, such as the SIR (id. at 4-6).

C. Remedy For Financial Condition

1. Introduction

The Company states that the Department granted it, consistent with other Department approved PBRs, "the option to petition the Department for changes to tariffed rates in extraordinary economic conditions" (Company Brief at 6, citing D.T.E. 05-27 at 400). Under this authority, Bay State seeks a change in its rates without abrogating the PBR (Company Brief at 6). Bay State states that the extraordinary economic conditions it faces include its poor financial condition, rates based on billing determinants that are not representative of Bay State's experience in the rate year and beyond, and the accelerated incremental capital investments required by the SIR program (id. at 12). Bay State argues that its PBR does not address the need for appropriate billing determinants nor the need to keep pace with accelerated non-revenue producing capital investment (id. at 12-16).

To remedy the extraordinary economic condition affecting Bay State, the Company requests that the Department approve two separate tariff changes (id. at 3). The first change is

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[5] Although not cited in the Company's Brief, this information may be found in Exhibit BSG/DPY-1 at 7.

a one-time adjustment to base distribution rates to adjust Bay State's billing determinants (id. citing BSG/JAF-1; BSG/JAF-2). The second is approval and implementation of Bay State's proposed SIR charge ("SIRC") to recover the incremental capital costs of the Company's accelerated SIR program expended since January 1, 2005 (id. at 3-4). We now describe these requested tariff changes in further detail.

2. Intermediate Adjustment to Base Rates

Bay State is requesting to increase its base rates by approximately $7.49 million (RR-DPU-12). The proposed base rate adjustment represents an approximate 5.25 percent increase to 2006 annualized base revenue of $143,343,825 (and a 1.5 percent increase to Bay State's 2004 test year operating revenue of $494,282,531) (id. at 2-3). The Company claims that its proposed adjustment is necessary to provide Bay State with a reasonable opportunity to achieve the targeted base revenue level approved by the Department in D.T.E. 05-27, but which the Company has been unable to realize due to the decline in AUPC (Company Brief at 3). The Company maintains that it is not requesting an increase to base rates to recover additional costs above the levels covered by the Company's approved PBR (id. at 1).

The Company proposes to increase base rates for all rate classes, to account for the decline in AUPC in the residential and small commercial rate classes (Exh. BSG/JAF-2, at 26-27).[6] The Company calculates the base rate adjustments in the following manner. First, to determine the 2004 AUPC, the Company divided the 2004 test year, weather normalized therm usage for each of the residential and small commercial classes by the number of

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[6] The rate classes are R&T 1, R&T 2, R&T 3, R&T 4, G&T 40, and G&T 50.

customers in that class in 2004 (Exhs. BSG/JAF-2, at 27; and, Sch. JAF-2-2-1). Second, to determine the 2006 AUPC, the Company divided the 2006 weather normalized therm usage for each of the residential and small commercial classes by the number of customers in that class in 2006 (Exhs. BSG/JAF-2, at 27; and, Sch. JAF-2-2-1). Third, Bay State subtracts the 2006 AUPC from the 2004 AUPC for each of the residential and small commercial classes to determine the decline in AUPC for the homogenous rate classes (Exhs. BSG/JAF-2, at 27; and, Sch. JAF-2-2-1). Fourth, the Company multiplied the decline in AUPC for each of the residential and small commercial classes by the volumetric base rate approved for that rate class in the Company's most recent PBR filing, D.P.U. 07-74, to determine the revenue reduction to each of these rate classes (Exhs. BSG/JAF-2, at 27; and, Sch. JAF-2-2-1). Fifth, the Company summed the revenue reductions to determine the total revenue adjustment. (Exh. BSG/JAF-2, at 27, 29; and, Sch. JAF-2-2-1).

The total revenue adjustment is allocated to all rate classes (residential, commercial (small and large), and industrial) based on each class's proportionate share of the current level of annualized base revenues (Exhs. BSG/JAF-2, at 28-29; and, Sch. JAF-2-2-1). To derive the proposed adjustments to base rates, the revenues allocated to each class are divided by the 2006 weather normalized therm usage for that rate class (Exhs. BSG/JAF-2, at 29; and, Sch. JAF-2-2-1).

3. Steel Infrastructure Replacement Charge

Bay State also requests that it be permitted to implement a SIR adjustment mechanism to recover the incremental costs of the Company's accelerated replacement of steel infrastructure[7] since January 2005 (Exh. BSG/JAF-1, at 3). Bay State's proposed SIRC would recover these incremental costs through Bay State's existing Local Distribution Adjustment Clause ("LDAC"). The Company estimated that the pace of pipe replacement in 2005 and 2006 was approximately 60 miles per year, or approximately 54 percent higher than the replacement rate contemplated by the Department in D.T.E. 05-27 (Exh. BSG/DGC-1, at 11).[8] The Company estimates it will invest up to an additional amount of $240 million over the next 12 years (Exh. BSG/JAF-1, at 4). The Company states that this significantly increased pace puts a correspondingly increased financial burden on the Company (Exhs. BSG/DGC-1, at 11; BSG/JAF-1, at 3-4). Bay State proposes that the SIRC take effect beginning November 1, 2008, following the Department's review of the SIR investments.[9]

To implement the SIRC, the Company proposes a revised LDAC tariff, which adds a separate section entitled: "Section 6.0 Steel Infrastructure Replacement Costs Allowable for LDAC - (SIR)" ("SIR tariff") (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff,

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7 The Company is replacing bare steel and unprotected coated steel.

8 The number of miles of bare steel mains replaced by the Company in calendar years 2004, 2005, 2006, and 2007 were 13.5, 57.6, 44.2, and 35.8, respectively for an average of 37.8 miles per year (RR-DPU-18 (b), Att. RR-DPU-18 (b) (Miles)). The corresponding total number of miles of all types of mains replaced for the same period was 26.0, 71.9, 66.2, 58.7, respectively for an average of 55.7 miles per year (RR-DPU-18 (b), Att. RR-DPU-18 (b) (Miles)).

9 The Company proposes to file with the Department, on or before June 1st of each year, information and schedules for Department review supporting its proposed SIR revenue requirement and the SIRC for the subsequent annual period beginning November 1st (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Sections 6.12, at 15).

M.D.P.U. No. 94, at 11-15). The proposed SIR tariff states that its purpose is to establish a procedure that allows Bay State to adjust its rates annually to recover the costs associated with its accelerated replacement of "Eligible Facilities," consisting of bare steel and unprotected coated steel distribution mains and other related facilities (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, at Section 6.01, at 11).

The proposed SIR tariff defines SIR investments to be the cost of Eligible Facilities that include the cost of main replacement projects, including any connected facilities such as services, meters or regulators that must be installed or replaced to enable the main replacement to become operational (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Section 6.04, at 11). More specifically, the SIR investments may include one or more of the following plant accounts: (1) Transmission Mains (Account No. 367); (2) Distribution Mains (Account No. 376); (3) Distribution Services (Account No. 380); (4) Meters (Account No. 381); (5) Meter Installations (Account No. 382); (6) House Regulators (Account No. 383); and (7) Industrial Measuring and Regulating Equipment (Account No. 385) (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Section 6.04, at 11).

The proposed SIR tariff states that the Company's SIR provides for the accelerated replacement of aging steel infrastructure in order to maintain safe and reliable service (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Sections 6.01, 6.03, at 11). The proposed SIR tariff provides that the SIR investments in a given SIR calendar year shall exclude a non-accelerated investment threshold in the amount of $4,041,244, the amount characterized as "the typical or historical average annual level of steel infrastructure replacement investment" (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Section 6.08(8), at 13).[10]

The proposed SIR tariff defines "SIR Eligible costs" to include depreciation, property taxes, return, and income taxes associated with total SIR investments since December 31, 2004 through the prior year,[11] plus the associated carrying charges based on the pre-tax cost of capital of 11.705 percent established in D.T.E. 05-27 (Exhs. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Sections 6.05, at 12; 6.09, at 14).

The proposed SIR tariff includes a credit for SIR savings, defined as the operations and maintenance ("O&M") leak repair offset ("O&M Offset") and calculated by comparing the corrosion leak repair activity of the previous year's SIR program year to the four-year average of leak activity for the period 2000 through 2003[12] (Exh. BSG/JAF-2, Sch. JAF-2-5-1;

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10 This amount of $4,041,244, which was the same amount proposed by the Company in its last rate case, is equal to the 2000-2003 four-year average cost of the "historic" level of steel infrastructure replacement. D.T.E. 05-27, at 10-11. In that Order, the Department noted Bay State's reason for not proposing to include expenditures for the 2004 test year, stating that its pipe replacement was accelerated in 2004 and, therefore, did not represent what typically occurred in the past. D.T.E. 05-27, at 11 n.11. The Department further noted that annual direct investments for the replacement of unprotected steel mains, services and other related facilities from 2000 to 2004 were $2.6 million, $5.2 million, $3.8 million, $4.6 million, and $6.2 million, respectively. D.T.E. 05-27 05-27, at 11 n.11; see also, RR-AG-3 for the 2004 amount.

11 The proposed SIR tariff defines "prior year" as the annual period ending immediately prior to the annual recovery period beginning November 1 (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Section 6.08(9) at 13).

12 The four-year period is from 2000 through 2003, instead of the 2000 through 2004 period stated in the proposed tariff (Exhs. BSG/JAF-2, Schs. JAF-2-5-3, at 2, col. 3; JAF-2-5-3, at 8; DPU 1-08, Att. DPU 1-08, at 11; Tr. 3, at 520). See D.T.E. 05-27,

(continued...)

Proposed Tariff, M.D.P.U. No. 94, Sections 6.06, at 12; 6.08(14) at 13). The proposed four-year average number of main corrosion leaks repaired is 719, with an average unit leak repair cost of $1,021 (Exhs. BSG/JAF-2, Sch. JAF-2-5-3, at 8; DPU 1-08, Att. DPU 1-08, at 11).[13]

The proposed SIR tariff includes a formula to be used as the basis for calculating the SIRC that recovers the aggregate SIR revenue requirement for investments made during the duration of the SIR program (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Sections 6.08 (13), at 13; 6.09, at 14-15). More specifically, the SIRC unit rate is equal to the sum of the SIR revenue requirement for the rate year and the SIR eligible costs reconciliation adjustment, inclusive of the associated carrying charge,[14] divided by the forecast annual throughput volume inclusive of all firm sales and firm transportation

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[12](...continued)
at 11-12.

[13] As the basis for calculating the proposed O&M Offset in D.T.E. 05-27, the Company proposed to use the same 719 average number of annual mains corrosion leaks repaired and the corresponding average unit cost of leak repair of $1,021 for the four-year period from 2000 through 2003 (Exhs. BSG/JAF-2, Sch. JAF-2-5-3, at 8; DPU 1-04, Att. DPU 1-04; DPU 1-08, Att. DPU 1-08, at 11; RR-NEGWA-1). See D.T.E. 05-27, at 12;

[14] The proposed tariff provides that the Company will record the accumulated difference between: (1) the revenues for recovering the SIR costs, calculated by multiplying the unit SIRC by the monthly firm sales and transportation throughput; and (2) the SIR Eligible costs allowed, plus carrying charge, calculated on the average monthly balance using the consensus prime rate as reported by the Wall Street Journal and then added to the end-of-month balance (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Section 6.10, at 15).

throughput (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Sections 6.09, at 14; 6.10, at 15).[15]

The proposed SIR tariff states that on or before June 1st of each year, the Company shall file with the Department information and supporting schedules for Department review and basis for approving the SIR revenue requirement and the SIRC for the subsequent annual period beginning November 1st (Exh. BSG/JAF-2, Sch. JAF-2-5-1; Proposed Tariff, M.D.P.U. No. 94, Sections 6.12, at 15).

In support for its proposed tariff, the Company provided illustrative schedules that show how the rate base, net of accumulated depreciation and accumulated deferred income tax,

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15 In D.T.E. 05-27, the Company proposed the Annual Base Rate Adjustment Mechanism ("ABRAM") to recover the incremental costs of its SIR. D.T.E. 05-27, at 10-14. The purpose of the ABRAM was to establish procedures that allow the Company to adjust, on an annual basis, its base rates for firm gas sales and firm transportation service pursuant to the Company's PBR and SIR program (Exh. DPU 1-03, Att. DPU 1-03, at 1-2). The Company stated that although its requests, both in D.T.E. 05-27 and in the instant docket, seek to recover the same categories of SIR costs, the primary differences between the two proposals are the recovery mechanism and timing, as well as the associated difference in the derivation of the applicable rates (Exh. DPU 1-04).

More specifically, the SIRC calculates a uniform cents-per-therm annual surcharge, which is applicable to all distribution rate classes; in the ABRAM, the total annual revenue requirement was allocated to each base rate component of each rate class by the percentage of the prior year total base revenues associated with each base rate component (Exh. DPU 1-04). Also, the SIRC is calculated using forecasted annual throughput, while the ABRAM was based on weather normalized calendar throughput of the prior year (Exh. DPU 1-04). In addition, the SIRC includes a reconciliation of actual costs with actual recoveries similar to the other elements of the LDAC, while the ABRAM rate treatment of SIR costs was non-reconcilable, like any other components of base rates (Exh. DPU 1-04).

is to be determined (Exhs. BSG/JAF-2, Sch. JAF-2-5-3; DPU 1-09, Supp).[16] More specifically, the Company initially calculated for year 2005 the total SIR program direct capital additions for (1) mains, (2) services, and (3) service tie-ins and other property, and deducted from each of these category of expenditures the corresponding amount of the 2000-2003 four-year average thresholds (Exhs. BSG/JAF-2, Sch. JAF-2-5-3; DPU 1-09 (Supp.); Tr. 3, at 399-400).[17] Then the Company grossed up each cost category by the costs of overhead[18] and reduced the annual total by the amount of bare steel retirement for 2005, resulting in the total net capital additions equal to $14,839,612 (Exhs. BSG/JAF-2, Sch. JAF-5- 3, at 2; DPU 1-09, Att. DPU 1-09 (Supp.) at 2).

Next, the Company used the component category costs of the calculated 2005 net capital additions as the beginning balances for 2006, added to these balances the 2006 SIR

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16 In its filing, the Company provided 2007 estimated capital additions under its SIR program for mains, services, and service tie-ins and other property (Exh. BSG/JAF-2, Sch. JAF-2-5-3, at 2). Subsequently, the Company provide actual values for 2007 (Exh. DPU 1-09, Att. DPU 1-09 (Supp.) at 2).

17 The 2000-2003 four-year averages for (1) mains, (2) services, and (3) service tie-ins and other property are $2,733,699, $1,083,234, and $224,311, respectively, the total of which is equal to the proposed $4,041,244 non-accelerated investment threshold (Exhs. BSG/JAF-2, Sch. JAF-2-5-3; DPU 1-09, Att. DPU 1-09 (Supp.) at 2, col. 3; DPU 1-04, Att. DPU 1-04; RR-AG-3). The same four-year averages are used in calculating the SIR Eligible costs for recovery for years 2005, 2006, and 2007 (Exhs. BSG/JAF-2, Sch. JAF-2-5-3; DPU 1-04, Att. DPU 1-04; DPU 1-09, Att. DPU 1-09 (Supp.) at 2, col. 3).

18 The Company applied overhead factors equal to 22 percent for 2005, 25 percent for 2006, and 24 percent for 2007 (Exh. DPU 1-09, Att. DPU 1-09 (Supp.) at 2, col. 5). For its 2008 through 2012 annual SIR program capital additions projections, the Company used an overhead factor of 26 percent (RR-DPU-23).

capital additions by category of costs, and subtracted the four-year average thresholds, following the same method used for 2005, except that the beginning balances in 2005 were zero (Exhs. BSG/JAF-2; Sch. JAF-2-5-3, at 2; DPU 1-09, Att., DPU 1-09 (Supp.) at 2).[19] The resulting actual total net capital additions for the three-year period from 2005 to 2007 is $43,498,219, the illustrative amount that would have to be recovered through the proposed tariff effective November 1 (Exh. DPU 1-09, Att. DPU 1-09 (Supp.) at 2).

The Company claims that the conditional opportunity provided by the Department for Bay State to petition for a one-time adjustment to base rates for its SIR program investments five years from the date of the Order in D.T.E. 05-27 is not an adequate remedy (Exhs. BSG/DGC-1, at 12; BSG/JAF-1, at 6). The Company states that the SIR program requires an annual capital spending level of approximately $20 million, which will amount to $100 million by the end of the five-year period in 2010 (Exhs. BSG/DGC-1, at 12).[20] The

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19 The Company's gross expenditures under its SIR program for 2005, 2006, and 2007 were $16,370,564, $16,155,574, and $15,201,680, respectively, for a total of $47,727,818 (Exh. DPU 1-09, Att. DPU 1-09 (Supp.) at 2, col. 2). The corresponding bare and unprotected coated steel retirements for 2005, 2006, and 2007 were $202,159, $187,993 and $135,253, respectively for a total of $525,405 (Exh. DPU 1-09, Att. DPU 1-09 (Supp.) at 2, col. 2).

20 The Company stated that it intends to invest an additional amount of $240 million over the remaining 12-year term of its SIR program, which is "a massive capital replacement undertaking to ensure a safe and reliable natural gas distribution system service for customers over the next 50-60 years" (Exhs. BSG/JAF-1, at 4; DPU 1-05). For years 2008 through 2012, the Company projects annual net SIR program capital additions of $11.9 million in 2008 and $14.9 million in 2009 through 2012, net of the average annual non-accelerated investment threshold of $4.041 million but including overhead costs (RR-DPU-23). The corresponding percentages of the annual net SIR program additions relative to total Company capital additions are 22.0 percent, 22.8 percent,

(continued...)

Company adds that under the one-time adjustment provision, Bay State will be able to recover the costs of these investments only if its earnings fall below six percent (Exhs. BSG/DGC-1, at 12; BSG/JAF-1, at 6). The Company claims that this provision is far too restrictive and confiscatory and will ensure that the Company's financial condition will remain poor due to inadequate rate relief for its SIR program (Exh. BSG/DGC-1, at 12).

The Company argues that although customers will receive long-term benefits from the SIR program, the Company will be unable to recover on a timely basis its capital costs, resulting in severe strain on its financial condition (id.).[21] The Company adds that the financial impact of the SIR program is cumulative because with each year of additional SIR costs, the Company's ability to carry these investments without cost recovery will be increasingly more difficult (id. at 12-13). The Company also notes that the Department's one-time base rate adjustment after five years could create a significant one-time rate shock for customers, followed by another rate shock after the expiration of the ten-year term of its existing PBR, rate shocks which Bay State maintains could be avoided by the proposed SIRC (id. at 13).

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[20](...continued)
25.6 percent, 27.4 percent and 27.7 percent, respectively (RR-DPU-23).

[21] The Company stated that for the period from January 2000 through December 2007, its total unaccounted-for-gas was 3,506,626 MMBtu at a cost of $28,931,800 (Tr. 2, at 355; RR-DPU-9). The Company, however, indicated that it would be difficult to calculate the portion of the unaccounted-for-gas that would be reduced through its SIR program, and that the possible acceleration of repairs of Type 3 leaks as a result of such program would not provide significant savings to the Company as opposed to the benefits of a safer system (Tr. 2, at 357-358).

IV. EXTRAORDINARY ECONOMIC CONDITIONS

Bay State's petition is the first time any jurisdictional utility operating under a PBR has sought relief under the extraordinary economic conditions provision. That provision provides, in pertinent part:

> In terms of Department precedent, when approving long-term PBRs the Department has taken note of remedies available to [c]ompanies under such plans. These remedies have included a formal mid-period review (see D.T.E. 01-56 at 10-11; D.T.E. 03-40 at 497), and acknowledgment that companies retain the option to petition the Department for changes in tariffed rates in reaction to extraordinary economic conditions. D.T.E. 03-40, at 497 n.263. The Department affords the Company both of these options in the instant case. In terms of the mid-period review, either the Company or the Department may initiate said review.

D.T.E. 05-27, at 400-401.

There is no "bright-line" standard defining extraordinary economic conditions. In this case, Bay State points to its financial condition, its declining AUPC, and its SIR, individually and combined, as extraordinary economic conditions.

As a remedy, Bay State seeks to increase base rates outside of a general rate case. Companies operating under a PBR are not expected to seek rate increases outside of the annual PBR adjustment mechanism, the exogenous cost provision, or the earnings sharing mechanism. See, e.g., Incentive Regulation, D.P.U. 94-158, at 22 (1995). Further, rate increases are usually reviewed in general rate cases pursuant to G.L. c. 164, § 94. See e.g., Massachusetts-American Water Company, D.P.U. 95-118, at 175 (1996); Housatonic Water Works Company, D.P.U. 95-81, at 3 (1996); Commonwealth Gas Company, D.P.U. 92-151, at 4

(1992); Boston Edison Company, D.P.U. 92-23/92-24, at 4 (1992); Tax Reform Act, D.P.U. 87-21-A at 6-7 (1987).

We shall now review Bay State's financial condition, its declining AUPC, and its SIR in our effort to determine whether the Department should grant Bay State its requested relief. We begin with the Attorney General's response to Bay State's description of its financial condition.

V. FINANCIAL CONDITION

A. Positions of the Parties

1. Attorney General

The Attorney General states that the Company's financial condition is the result of its own management decisions and does not justify the relief sought (Attorney General Reply Brief at 10). The Attorney General argues that the Company's interpretation of its ROE, dividend history, and NiSource bond rating is not indicative of the Company's true financial condition (id. at 10-11).

First, regarding the Company's ROE assertions, the Attorney General states that Bay State's 2006 ROE is not representative of its future earnings (id. at 16). For example, in 2007 and in later years, according to the Attorney General, Bay State received and will continue to be eligible for price index, exogenous cost, and earnings sharing rate adjustments (id.). Also, the Attorney General states that Bay State's AUPC increased in 2007 (id.).

Further, the Attorney General argues that Bay State's projections of ROE for the future are speculative and inherently unreliable (id. at 16). The Attorney General points out that the speculative nature of the forecast is borne out by the fact that the first year of the forecast (2007) is wrong (forecast at less than six percent, when actual was greater than eight percent), making any year thereafter even more suspect (id. at 18).

Second, the Attorney General argues that NiSource's decision whether to take annual payments of dividends from its subsidiary Bay State, during any period, has nothing to do with the financial health of the Company (id. at 11). The Attorney General reasons that since NiSource is Bay State's sole shareholder, all of Bay State's dividends eventually flow to NiSource (id.). The Attorney General claims that Bay State's dividend history since 2002 indicates there is no relationship between earnings, the financial health of the Company, and the amount of dividends it pays out (id. at 11-12). By way of example, the Attorney General compares Bay State's dividends paid in 2002 of almost all of its income with no dividends paid in 2004, when the Company's income more than doubled (id. at 12).

Third, the Attorney General disputes Bay State's assertion that NiSource's downgrade by S&P in December 2007 was because of Bay State's declining AUPC and SIR (id. at 12-14). Rather, the Attorney General claims that the downgrade is the result of S&P's assessment of NiSource's utility acquisitions and added debt (id. at 12).

Finally, the Attorney General criticizes the Company's failure to recognize revenue increases since the establishment of its rates in D.T.E. 05-27. She claims the Company does not include margin sharing, pension/PBOP recovery, and lost base revenue recovery (Attorney General Brief at 8, 35-36).

2. Bay State

The Company claims that the Attorney General's reliance on the PBR revenue adjustments, margin sharing, and pension/PBOP revenues to mitigate the Company's financial condition is misplaced (Company Reply Brief at 22-23). The Company asserts that it has included all relevant PBR adjustments in its projections of rate of return and they do not provide significant improvement to the Company's financial condition (id. at 22- 23, citing RR-DPU-20).

Further, Bay State points out that the margin sharing and pension/PBOP adjustments are not base revenue increases. Margin sharing provides an associated revenue reduction to customers through the Cost of Gas Adjustment Clause (id. at 22-23). The pension/PBOP adjustments relate to actual expenses (id. at 23). The adjustments do not offset any earnings erosion associated with the decline in AUPC or SIR investment (id.). Finally, Bay State notes that its AUPC-adjusted base rate calculations implicitly reflect lost base revenues (id. at 24, citing RR-DPU-18(a)).

Bay State projects that if the Department grants only the AUPC adjustment, the Company's ROE will not exceed eight percent and will decline to six percent by 2014 (id. at 3). Bay State projects that if the Department grants only the SIR adjustment, the Company's ROE will remain flat at eight percent until 2014 (id.). Finally, Bay State states that only with the approval of both the AUPC and SIR adjustments does the Company's projected ROE ever reach as high as ten percent through 2013, taking into consideration all adjustments to Bay State's revenue requirements adopted in D.T.E. 05-27 (id.).

B. Analysis and Findings

Bay State contends that its poor financial condition is evidenced by its consistently low earned ROE, the recent downgrade of its parent company's debt, and the Company's failure to pay dividends in recent years. The Company also maintains that this state of affairs will remain in place without the requested rate relief. In turn, the Attorney General argues that Bay State's financial condition is the result of its own management decisions and does not justify the relief being sought here.

Bay State's reliance on its 2006 ROE has two problems. First, Bay State has been operating only for two years under its ten-year PBR. The Company earned 4.06 percent (or 5.71 percent, weather-normalized) in 2006 but, in 2007, Bay State earned approximately 8.26 percent (or 7.34 percent, weather normalized). We agree with the Attorney General that Bay State's 2006 ROE may not be considered at this time as representative of Bay State's future earnings. It is only one year out of a ten year PBR. Further, the 2006 ROE only incorporated two months of the annual PBR adjustments.[22]

Second, ROEs are variable from year to year. If we expand the scope of ROE review to three years, we see that the Company's earned ROE for the years 2005 through 2007, ranged between 4.06 percent and 13.37 percent (RR-DPU-7, Att. at 1). On a weather-normalized basis, the ROE ranged between 5.71 percent and 11.75 percent (id.).

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22 The Company's annual PBR adjustment takes effect November 1st each year. The November 1, 2006 adjustment was Bay State's first adjustment under its PBR.

Perhaps more important to Bay State's claim for relief, then, is the Company's contention that it will never earn its allowed ROE of ten percent during the term of the PBR due to the decline in AUPC and the SIR. In support of this claim, Bay State offers a multi-year projection that predicts Bay State's ROE will not exceed eight percent during the term of the PBR and will fall to approximately four percent in 2014 (RR-DPU- 20).[23] However, multi-year forecasts are not used in ratemaking circumstances. See, e.g., Western Massachusetts Electric Company, D.P.U. 957, at 8-18 (1982). The unreliable nature of forecasts is borne out by the fact that the Company originally predicted its 2007 ROE at approximately six percent, when in fact it was approximately eight percent (Exh. AG 2-10; RR-DPU-7).

Bay State also points to NiSource's bond ratings, which are the lowest of investment grade ratings, as supporting its claim that the Company's earnings are insufficient to meet the demands of the financial marketplace (Company Brief at 2).[24] The Department's long-standing practice is to evaluate regulated affiliates of holding companies on a stand-alone basis. Massachusetts Electric Company, D.P.U. 800, at 51 (1982); New England Telephone and Telegraph Company, D.P.U. 411, at 49 (1981); Lowell Gas Company, D.P.U. 19037/19037-A at 38-39 (1977); see also Massachusetts Electric Company v.

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[23] The Company included all future PBR and earnings sharing adjustments in the forecast (RR-DPU-20; RR-DPU-21).

[24] Moody's Investor Services, Fitch Ratings, and S&P rate NiSource at Baa3, BBB, and BBB-, respectively. These ratings are just above the speculative rating for all three companies (RR-DPU-1).

Department of Public Utilities, 376 Mass. 294, 301-302 (1978). The Department is well-aware that the bond ratings for, and the financial condition of, an operating utility may differ from those of its parent company. Buzzards Bay Gas Company, D.P.U. 7986, at 3-4 (1948). Importantly, just as the Department would not rely on the parent company's required cost of equity in determining the cost of equity for a regulated subsidiary, it would be inappropriate to draw empirical conclusions about a regulated subsidiary's financial condition based on its parent company's financial state.

Even if the Department were to consider NiSource's bond rating as a proxy for that of Bay State, we note that Moody's Investor Service and Fitch Ratings have given NiSource the lowest of investment grade bond ratings since 2004, well before Bay State's claimed extraordinary decline in AUPC and the implementation of its SIR (RR-DPU-1). S&P's recent downgrade of NiSource's bond rating is still comparable with the ratings ascribed by the other rating agencies (id.). We cannot conclude, as Bay State asks us to, that this downgrade illustrates an inability to attract capital due to the declining AUPC and SIR. S&P states the "rating downgrade reflects NiSource's newly aggressive capital spending program, which will result in negative free cash flow and increased debt levels, reversing years of deleveraging. The company also announced the addition of two electric power plants ... and several pipeline expansions" (Exh. AG 7-11). S&P goes on to say: "We characterize the company's financial risk profile as aggressive due to its high debt leverage, weak cash flow metrics, and pursuit of an MLP strategy, which will reduce consolidated cash flow from stable"(id.). Further, S&P mentions Bay State: "NiSource had been improving its balance sheet after the acquisition of

Bay State and Columbia, in 1999 and 2000, respectively. In November 2007, NiSource initiated a more aggressive growth plan, which includes capital spending of more than $1 billion a year, which is above its near-term cash flow generating capability" (id.). In conclusion, the evidence on NiSource's bond ratings does not establish a causal link between the Company's operations and the NiSource downgrade. Therefore, the Department finds that Bay State has not demonstrated that the NiSource bond ratings, including the downgrade by S&P, in and of itself, is an indication of the Company's financial stability.

The Company also points to its failure to pay dividends in 2006 and 2007 as evidence of its poor financial condition. The decision whether to pay dividends and the amount to be paid is traditionally the prerogative of a company's management acting through its board of directors, taking into account legal constraints, capital structure issues, earnings stability, taxes, and the role dividends play in providing investors signals about a company's financial strength and future profit potential. Boston Edison Company, D.P.U./D.T.E. 97-63, at 26 (1998); Hingham Water Company, D.P.U. 19744, at 8-9 (1979). Bay State states that the primary factors considered in its decision on whether to pay dividends are its then-current debt to equity ratio and its then-current capitalization levels compared to total rate base (RR-DPU-6). However, Bay State has no express dividend payout policy, and therefore, we cannot conclude that the failure to pay a dividend in any given year is indicative of Bay State's financial well-being. Accordingly, the Department finds that the Company's dividend payouts are not necessarily demonstrative of Bay State's overall financial condition.

In conclusion, we recognize the Company's concerns about its financial condition given its ROE in 2006 and 2007. The record, however, does not clearly support the Company's conclusions regarding its future earnings. Therefore, we cannot determine based on the record that Bay State's financial condition warrants granting it the requested relief. We will now review the record with respect to AUPC and the SIR to determine if those factors lend additional and conclusive support to Bay State's claim for intermediate relief due to extraordinary economic conditions. We begin with the Attorney General's response to Bay State's claim that it has experienced a dramatic and permanent decline in AUPC.

VI. AVERAGE USE PER CUSTOMER

A. Positions of the Parties

1. Attorney General

The Attorney General contends that the rates that were set in D.T.E. 05-27 do not need an adjustment to account for the decrease in AUPC (Attorney General Brief at 30-31). The Attorney General maintains that the Company's experience with declining AUPC in 2005 and 2006 was not extraordinary and is not permanent in nature (id. at 31).

The Attorney General argues that AUPC normally varies from year to year, and, therefore, cannot be the basis for Bay State's requested rate increase (id. at 32). She notes that usage varies with weather, demand-side management ("DSM") programs, the economy, and the price of natural gas and competing fuels (id.). The Attorney General points to Bay State's own experience as proof of the variable nature of customer usage. After Bay State experienced reductions in AUPC in 2005 and 2006, the Attorney General notes that Bay State had an increase in AUPC in 2007 (id.). The Attorney General concludes that Bay State's AUPC decline in 2005 and 2006 was not extraordinary but rather well within the expected range of year-to-year changes (id.).

The Attorney General acknowledges that Bay State's customers probably did respond to the increase in gas prices during the fall of 2005, which would account for some of the decline in AUPC that Bay State experienced (id. at 33-34). After that price increase, however, the Attorney General claims that customers eventually would return to their previous comfort levels and increase their usage, and calls this a "snap-back" effect (id. at 34).[25]

The Attorney General lists other reasons why Bay State's decline in AUPC in 2005 and 2006 are likely to be an anomaly and not a new trend (id. at 32). The Attorney General argues that Bay State's usage numbers are not actual usage (but are weather normalized) (id. at 33). The Attorney General asserts that, because the heating season in 2006 was so much warmer than normal, the weather normalization process understated AUPC data for 2006 (id.).[26]

The Attorney General asserts that the Company has many ways to mitigate the drop in AUPC including: (1) reducing costs; (2) adding new customers; and (3) converting non-heat customers to gas heat (Attorney General Brief at 34). In addition, the Attorney General claims

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25 The "snap-back" concept was developed in the gasoline industry and suggests that consumers acclimate to higher prices over time making the full amount of the decline in AUPC temporary (Exh. AG-1, at 19-20).

26 The Attorney General explains that the weather normalization process assumes that customers' responses to temperature change are linear during each month (Attorney General Brief at 33). The Attorney General claims that customers' responses to temperature change are not linear and this fact skews weather normalized data in an abnormally warm year (id.).

that the $9.4 million the Company has received due to the price cap and earnings sharing mechanisms established within the PBR in D.T.E. 05-27 more than offset the $7.5 million revenue reduction the Company claims is due to the decline in AUPC (id. at 35). Further, the Attorney General points out that the Company's proposal allows it to retain the benefits to shareholders of the revenues associated with the increase in sales derived from new customers (Attorney General Reply Brief at 19).

The Attorney General argues that the Company's requested rate adjustment does not take into account the lost base revenues that Bay State has received associated with the DSM programs that it administers (Attorney General Brief at 36). The Attorney General states that, although these DSM programs contributed to the decrease in usage observed by the Company in this case, Bay State has made no attempt to offset the proposed rate adjustment by the lost base revenue recovery associated with these DSM programs (id.).

Finally, the Attorney General asserts that the PBR established in D.T.E. 05-27 is working properly. The Attorney General contends that the PBR considers AUPC through the following mechanisms: (1) the productivity factor in the PBR mechanism that takes into account the historic drop in AUPC; (2) the allowed rate of return used to establish the cast off rates in D.T.E. 05-27 was based on investors' expectation that AUPC would continue to decline; and (3) the retention of increased revenues associated with new customers added to the Bay State system since the rate year (Attorney General Reply Brief at 18-19, citing Tr. 3, at 557-558).

2. Bay State

The Company states that the AUPC rate of decline for the two-year period 2004 and 2006 is more than seven times the rate of decline for the 13-year period leading up to 2004 (Company Brief at 23, citing Exh. BSG/DPY-1, at 7-8). Bay State also relies on its expert witnesses, who testified that the overall trend is a significant decline (Company Brief at 24-25; Company Reply Brief at 19). Bay State maintains that the declines in AUPC since the 2004 test year used to establish its cast-off rates as part of the Company's PBR plan are significant for its residential and small commercial rate classes (Company Brief at 21-22, citing Exh. BSG/DPY-1, at 6; BSG/DPY-1, Sch. DPY-1). The Company contends that its weather-normalized AUPC for the Company's residential customer classes declined by 8.7 percent from 2004 through 2006, while AUPC for small commercial customers declined by 8.3 percent over the same time period (Company Brief at 21-22, citing Exh. BSG/DPY-1, at 6; BSG/DPY-1, Sch. DPY-1).

As further evidence of the claimed permanence of the decline in AUPC, the Company notes that it is well-established in economic literature that the long-run response to energy prices is greater than the short-run response to energy prices (Company Brief at 25, citing Exh. BSG/LRK-1, at 12). For example, Bay State cites to a 2007 American Gas Association ("AGA") study that estimates the long-run price elasticity (-0.18) for natural gas is twice as high as short-run demand (-0.09) (Company Brief at 25-26, citing Exhs. BSG/LRK-1, at 12; AG 4-1; AG 4-2). Bay State further states that power generation as well as other demands for natural gas will continue to place upward pressure on gas commodity prices (Company Brief at 26, citing Exhs. BSG/LRK-1, at 12; BSG-AG-1-23). Finally, Bay State contends that increased energy efficiency and customer behaviors, as well as the significant public policy emphasis here in the Commonwealth and nationally will further promote reductions in energy consumption (Company Reply Brief at 20).

The Company disputes the Attorney General's claim that the weather normalization techniques should not be relied upon, claiming that the Department previously approved the method in their calculations in D.T.E. 05-27, at 53-54 (id. at 21). Additionally, the Company disputes the "snap-back" effect presented by the Attorney General (id. at 20). The Company maintains that this concept is drawn from gasoline market and it is speculative to apply the experience of the gasoline markets to natural gas markets (id., citing Tr. 3, at 597-598, 601-602, 617).

In response to the Attorney General's claim that the Company could mitigate the loss in AUPC by adding new customers, the Company states that the additional costs associated with adding new customers offsets the increase in revenues (Company Reply Brief at 21, citing Tr. 3, at 558). The Company argues that it is unable, in most cases, to add non-heating customers because of inadequate returns on the required investment, and that even the addition of heating load and larger customers requires a careful evaluation to ensure that the associated construction and marginal costs do not create a drag on earnings (Company Reply Brief at 21-22).

Regarding the Attorney General's claim that PBR revenue increases mitigate the Company's financial condition, the Company states that it has included these increases in its projection of its future ROE (id. at 22, citing RR-DPU-20; RR-DPU-22). With respect to lost base revenue recovery, the Company states that it recovers lost base revenues only for DSM savings that Bay State administers, and that lost base revenues represent only a portion of declining AUPC (id. at 24, citing RR-DPU-3). The Company claims that its AUPC-adjusted base rate calculations, both presented in this proceeding and proposed on a going forward basis, implicitly reflect any lost base revenue recovery (id. citing RR-DPU-18(a)).

The Company concludes that the declining trend in AUPC will be permanent and sustained and will lead to persistent under-earning for the remaining years of Bay State's PBR (Company Brief at 26). The Company asserts that it has not and will not experience AUPC near the 2004 levels for the remainder of its PBR (id.).

B. Analysis and Findings

In D.T.E. 05-27, the Department established Bay State's new base rates by dividing the new revenue requirement by a representative level of customers and usage, i.e., billing determinants. The question before us is whether the test year billing determinants used to set rates in D.T.E. 05-27 are representative of the consumption that Bay State was to experience in the rate year and beyond.

Bay State claims that the test year billing determinants are no longer accurate because they do not reflect the unexpected, dramatic, and permanent decline in AUPC per customer that occurred since the 2004 test year (Exh. BSG-1.D; Company Brief 20-26). On the other hand, the Attorney General argues that changes in AUPC are to be expected (Attorney General

Brief at 32). The Attorney General further claims that declines in AUPC due to price are temporary and will "snap-back" to normal usage levels (Exh. AG-1, at 19-20).

The record shows that Bay State's AUPC declined from 1996 to 2004 at an average annual rate of 1.1 percent (Exh. BSG/DPY-1, at 7). Therefore, a certain amount of declining AUPC should have been expected by Bay State. In 2005, however, the AUPC for residential customers declined by 6.9 percent from the 2004 level, six times the rate from 1996 to 2004 (id. at 6). Certainly, the 2005 AUPC can be considered a departure from Bay State's historical trend.

In 2006, Bay State's AUPC declined 2.0 percent from the 2005 level (id.). Bay State continues to describe the 2006 AUPC as a significant departure from Bay State's historical level and the 2004 AUPC on which its current rates depend. The 2006 AUPC, however, when coupled with data from 2007, can be viewed in a different way. Data for 2007 show an increase in AUPC of 2.1 percent from 2006 (RR-DPU-15, Att. at 1-2). Thus, in 2006 the decline in AUPC slowed to within the historical rate and then reversed itself in 2007.

During this time, 2006-2007, the price of the commodity of natural gas was moderating from the highs of 2005 (RR-DPU-16). The annual average U. S. natural gas price in 2004 was $5.45 per Mcf,[27] in 2005 was $7.32 per Mcf, in 2006 was $6.40 per Mcf, and in 2007 was $6.39 per Mcf (id.). The highest-price period during the 2004-2007 period was from September, 2005 through January, 2006, with a price range of $10.33 per Mcf in October, 2005 and $8.02 per Mcf in January, 2006 (id.). Whether the 2007 increase in AUPC is due to

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[27] Mcf is one thousand cubic feet of natural gas.

the price moderation, “snap-back,” or other factor is unclear. The Department’s experience with water demand supports the position that the concept of “snap-back” is not unique to the sales of gasoline. Plymouth Water Company, D.T.E /D.P.U. 06-53, at 34-35 (2007).

Given that in one year (2007) out of the three since Bay State’s test year there was an increase in AUPC, we cannot find that the combined decline in AUPC from 2005 and 2006 is permanent. Therefore, the Department declines to use the Company’s experience with AUPC in 2005 and 2006 as an extraordinary circumstance requiring us to reset Bay State’s rates. With this finding we need not discuss the Attorney General’s arguments regarding weather-normalization, mitigation, and AUPC recovery through the DSM and PBR mechanisms.

In conclusion, we recognize declining AUPC as a phenomenon in the gas industry. The record, however, does not clearly support the Company’s conclusions that its experience is unique and a significant departure for the historic trend in AUPC. Therefore, we cannot determine based on the record that Bay State’s AUPC levels in 2005, 2006, and even 2007 warrant granting it the requested relief.

In view of the inconclusive nature of the evidence regarding (1) the Company’s financial condition, (2) the level and duration of the decline in AUPC, and (3) the limited two year experience under the Company’s PBR, the Department cannot use these factors to approve the extraordinary measure of adjusting Bay State’s rates outside of a traditional rate case. We will next review the Company’s request that we approve its proposed SIR tariff, again beginning with the Attorney General’s critique of the Company’s proposal.

VII. BAY STATE'S STEEL INFRASTRUCTURE REPLACEMENT PROGRAM

A. Positions of the Parties

1. Attorney General

a. Introduction

The Attorney General characterizes the Company's renewal of its request for SIR cost recovery as a motion for reconsideration of the Department's decision in D.T.E. 05-27 denying the Company recovery of SIR costs (Attorney General Brief at 17, 37-38, 46; Attorney General Reply Brief at 2, 19, 26).[28] The Attorney General states that the Department should reject the proposed SIR tariff because the Department's decision in D.T.E. 05-27 was correct (Attorney General Reply Brief at 20-21). Further, the Attorney General argues that the Company's geographic approach to replacing mains is flawed (id. at 22-24). Finally, the Attorney General states that there are several flaws with the proposed SIR tariff implementing the SIR (Attorney General Brief at 38-45). In the following sections, we will describe the Attorney General's arguments in more detail.

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[28] In D.T.E. 05-27, the Department stated that: "In the event and to the extent that the SIR program may cause the Company's earnings to fall below the lower threshold of the earning sharing mechanism determined elsewhere in this Order and only to the extent that the Company's plant investment through careful and contemporaneous documentation meets the prudent, used and useful test, the Company may after five years from the date of this Order petition the Department for a one-time base rate adjustment arising solely from its accelerated steel replacement program." D.T.E. 05-27, at 49-50.

b. Reconsideration of Department's Decision in D.T.E. 05-27

The Attorney General states that the proposed SIRC is substantially the same as that which was proposed and rejected in D.T.E. 05-27 (Attorney General Brief at 37). The Attorney General claims that the reasons the Department previously rejected the tariff in 2005 still hold true now (id. at 37). For example, the Attorney General states that there was a significant slowdown in the pace of the Company's replacement of its unprotected steel mains during the merger rate freeze period (Attorney General Reply Brief at 20, citing D.T.E. 05-27, at 46).

In addition, the Attorney General recites the finding in D.T.E. 05-27 that the SIRC is inherently incompatible with the purpose of the Company's PBR (Attorney General Reply Brief at 20, citing D.T.E. 05-27, at 48). The Attorney General argues that exempting a subset of costs, which are attributable to the Company's SIR program, from a PBR mechanism would dilute, if not defeat, the purpose of the shift from a traditional cost-of-service rate framework to an incentive regulatory paradigm (Attorney General Reply Brief at 20, citing, D.T.E. 05-27, at 48). For example, the Attorney General argues that the existing PBR productivity factor will be mis-specified if the Department approves the SIRC because the PBR productivity factor is intended to compensate the Company for certain rates of capital spending and price increases (Attorney General Brief at 37).

In addition to the findings in D.T.E. 05-27, the Attorney General lists other reasons to reject the Company's proposed SIRC. For example, the Attorney General notes the SIRC will remove the incentive for the Company to minimize the costs of its capital additions (Attorney

General Brief at 37). The Attorney General adds that the SIRC will be a regulatory burden on the Department because it requires a rate case every year (id.). The Attorney General also states that if Bay State's proposal is approved, all other utilities in the Commonwealth will file similar proposals (id. at 37-38).

c. Geographic Approach to Main Replacement is Flawed

The Attorney General asserts that the Company's proposed geographic approach for main replacement in its SIR program is flawed. First, the Attorney General criticizes Bay State's geographic approach because it replaces one hundred percent of its unprotected steel mains and services at customers' expense, rather than addressing the most risky segments of pipe first and then reviewing its leak rate to determine the need for continued accelerated replacement (Attorney General Reply Brief at 23, citing Tr. 2 at 320-321).[29] The Attorney General contends that after three years of using the "geographic" approach, it is clear that it is not as effective at reducing the Company's leaks per mile compared to replacing the worst pipes first (Attorney General Reply Brief at 23, citing Exhs. AG 3-1; AG 3-2; AG 3-4). The Attorney General claims that the geographic approach will result in the replacement of Bay State's entire unprotected steel distribution system rather than only the parts in need of replacement (Attorney General Reply Brief at 22).

[29] The Attorney General notes that the geographic approach targets only the "worst large segments of various systems" (Attorney General Reply Brief at 23, n.14, citing Tr. 2, at 320-321). The Attorney General claims that this approach is problematic because it ignores the worst small segments, which could be just as hazardous and leaky as a large segment (Attorney General Reply Brief at 23, n.14).

Further, the Attorney General argues that by not replacing the worst-performing mains first, these pipes will continue to leak at an accelerating rate and have a two-fold effect on the SIR program (id. at 22). The Attorney General first states that leaking mains will require additional O&M expenditures for repair, which will reduce the benefit that customers would receive from the O&M Offset under the SIRC cost calculation (id.). The Attorney General next states that these leaky mains will put upward pressure on the Company's leaks per mile, which in turn will require an accelerated SIR program until 100 percent of the unprotected mains are replaced (id.).

The Attorney General asserts that the Company's proposal is the most costly way to address its corrosion leak rate and has not demonstrated a least-cost approach to main replacement (id.). The Attorney General claims that the geographic approach is not cost-effective because it assumes that replacing the entire unprotected steel system on an accelerated basis is cheaper than just replacing those sections in need of replacement (id.).

The Attorney General, accordingly, recommends that the Department reject the Company's second attempt to impose the SIR program costs on customers' rates, and instead for the Department to consider a proposal in the fifth year of the Company's PBR as originally ordered by the Department (id. at 24, citing D.T.E. 05-27, at 50). In addition, the Attorney General recommends that the Department order the Company to reconfigure its SIR program to prioritize the replacement of the worst segments of mains first (Attorney General Reply Brief at 24).

d. Tariff Flaws

The Attorney General also asserts that the proposed SIR tariff has a number of flaws that will allow the Company to over-collect its cost for capital additions (Attorney General Brief at 38). These flaws include the following:

- that the SIR tariff makes no provision for the rate changes associated with any base rate cases that might occur during the term of the Company's SIR program (id.);
- that the SIR tariff does not make any provision for the retirement of steel pipe and other plant and the associated reduction in costs of depreciation, return, income taxes, and property taxes (id. at 39);
- that the proposed SIR tariff provides for the recovery of the costs of plant under distribution services, meters, meter installation, house regulators, and industrial measuring and regulating equipment (id.);
- that there is also no provision in the proposed SIR tariff for crediting of cost reductions related to the retirement of replaced services, meters, meter installations, house regulators, and industrial measuring and regulating equipment (id. at 40);
- that the proposed SIR tariff allows the Company to double-recover the carrying costs associated with its construction work in progress (id. at 40-41);
- that the proposed SIR tariff fixes the cost of capital at 11.705 percent, which is the pre-tax rate of return on rate base established in D.T.E. 05-27, for the entire 15-year term of the SIR program rather than a current cost of capital (id. at 43-44); and,
- that the proposed SIR tariff inappropriately calculates a monthly carrying cost based on an annual rate of return. More specifically, the Attorney General notes that the Company includes in its SIRC formula a carrying cost calculated monthly as the product of the Company's pre-tax rate of return multiplied by the accelerated gross plant investments associated with the SIR program plant placed in service, but not yet recovered through rates (id. at 44).

Moreover, the Attorney General notes that the proposed SIR tariff fixes the threshold amount of non-accelerated pipe investment at a "historical" average of $4,041,244 over the 15-year term of the SIR program and fails to inflate this threshold level (id. at 41-42). The Attorney General reasons that this approach fails to reflect the fact that the Company is compensated for the increasing costs associated with all its activities, including its non-accelerated pipe investment, through the inflation factor included in its PBR (id. at 42).

The Attorney General similarly claims that the proposed SIR tariff fixes the average cost rate of leak repair used in the O&M Offset at $1,021 for the entire 15-year term of SIR program and fails to inflate this cost level (id.). The Attorney General asserts that this approach fails to reflect the fact that the Company is compensated for the increasing costs associated with all its activities, including its leak repair costs, through the inflation factor included in its PBR (id.).

2. NEGWA

NEGWA opposes Bay State's petition and urges the Department to deny the Company's requested SIR tariff for a number of reasons (NEGWA Brief at 1, 8). Chiefly, NEGWA claims that Bay State's proposed SIR tariff is essentially identical to the rate recovery mechanism that was proposed and rejected in D.T.E. 05-27 (id. at 1-2, citing Tr. at 45; D.P.U. 05-27, at 36-39, 49-51). NEGWA states that the Department in D.T.E. 05-27 stated that these SIR costs are not recoverable through a separate mechanism during the Company's PBR term (NEGWA Brief at 2-3, citing D.T.E. 05-27, at 27, 39).

NEGWA also asserts that Bay State failed to demonstrate that the costs incurred for the SIR program are "extraordinary" or "unexpected" and, therefore, failed to provide a basis for the requested relief (NEGWA Brief at 2). NEGWA contends that the Company failed to present any careful and contemporaneous documentation that its SIR program meets the used and useful test applicable to rate treatment for capital additions (id. at 2, n.2, citing Tr. at 458-460, 465; D.P.U. 05-27, at 50).

NEGWA also contends that Bay State failed to demonstrate that the SIR program costs incurred and the 2005 decrease in residential AUPC caused the Company's poor financial situation (NEGWA Brief at 4, citing Exhs. AG-1; AG-2; Tr. at 77-78, 161-162). In addition, NEGWA asserts that Bay State failed to provide adequate information that serves as the basis for the Department to assess the overall validity of the SIR rate recovery, and claims that the evidence suggests that the Company has used the SIR program for the purpose of maintaining and expanding its throughput capacity, rather than for the principal purpose of leak reduction and advancing safety and system reliability (NEGWA Brief at 6-8).

3. Bay State

a. Response to Attorney General's Claims

The Company argues that the Attorney General's assertions are unfounded and should be rejected by the Department (Company Reply Brief at 24). The Company specifically addresses the allegation that the Company "gold plates" its infrastructure system, stating it minimizes costs by adopting the geographic approach (id. at 25).

The Company also addresses the allegation that annual SIRC filings would be a burdensome process. The Company states the SIRC spreads out the review over time, thus minimizing the number of projects that would be reviewed at any one time (id. at 25). Similarly, the Company asserts that there is no evidence to support the Attorney General's statement that approving Bay State's proposal would cause other utilities to propose similar charges (id.).

The Company also addresses the Attorney General's comments that the proposed SIR tariff has flaws. The Company claims that, on the contrary, the record demonstrates that Bay State has developed a cost-effective SIR program, which will benefit customers for many years into the future and put Bay State ahead of other local distribution companies in implementing a pro-active infrastructure replacement program (id. at 26, citing Exhs. BSG/LRK-1, at 14; DPU 1-02(i), Att. at 47).

b. Response to NEGWA's Claims

The Company asserts that most of the issues raised by NEGWA are not relevant to this proceeding (Company Reply Brief at 32). For example, Bay State argues that the issues raised by NEGWA concerning the prudence of the SIR program, its design, and whether it should be scaled backed are not relevant to this proceeding based on the scope established by the Hearing Officer (id. at 32). The Company also claims that NEGWA's concerns are matters that are properly within management's prerogative (id.). Also, regarding NEGWA's claim that Bay State may be using the SIR to expand its throughput capacity rather than to improve system reliability and safety, the Company maintains that its witness completely refuted this argument (id. at 33, citing Exh. BSG/DGC-1).

B. Analysis and Findings

As the Attorney General and NEGWA note, the Department has reviewed and rejected recovery of Bay State's SIR in D.T.E. 05-27, at 49. Also as noted by the Attorney General and NEGWA, a primary reason the Department rejected the proposed recovery for SIR costs in that proceeding involved a discussion of the validity of the stated purpose of the SIR. D.T.E. 05-27, at 42-43.

In its prior rate case filing, Bay State argued that the SIR was an accelerated steel infrastructure replacement program for its aging bare steel and unprotected coated steel. Id. at 30-31. The Company also stated that the SIR was required by accelerating leak rates. Id. at 33-34. The Department disputed the Company's characterization of the SIR as an accelerated program and determined that the SIR was at a rate similar to what the Company historically replaced from 1985-2003.[30] Id. at 40, 47. The Department noted that during the five years prior to the D.T.E. 05-27's historic test year of 2004, a five-year period under which the Company operated under a rate freeze, the Company reduced its infrastructure

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30 The Company was proposing to replace 38.9 miles of bare steel and unprotected coated steel per year. D.T.E. 05-27, at 47. The Department found that the average annual replacement rate for 1985-2004 was 37.3 miles per year. Id. at 40. The Department found that the average annual replacement rate for 1985-1998 was 45.08 miles per year. Id. The Department found that the average annual replacement rate for 1998-2003 was 18.0 miles per year. Id. at 40-41.

replacement to 18.0 miles per year even though Bay State's leak rate accelerated.[31] Id. at 40-42. The Department stated that, during the rate freeze, the Company replaced steel infrastructure at a pace significantly less than the pre-rate freeze period. Id. at 42-43.

In the present proceeding, the Company claims that the SIR accelerates the replacement of its bare steel and unprotected coated steel at a rate of 60 miles per year at a cost of $20 million per year for a total of $300 million over 15 years (Exh. BSG/DGC-1, at 3, 11). In 2005, 2006, and 2007, however, the Company replaced 312,976 feet, 267,301 feet, and 214,814 feet, respectively, of bare steel and unprotected coated steel mains (Exhs. DPU 1-01, Att. DPU 1-01(A) 2005 SIR Report at 4; DPU 1-01, Att. DPU 1-01(B) 2006 SIR Report at 4; DPU-1, Att. at 1; see also, RR-DPU-18(b), Att. RR-DPU-18(b) (Footage) at 1). Converting this footage into miles, the corresponding miles of bare and unprotected coated steel mains replaced by the Company for 2005, 2006, and 2007 were 59.28 miles, 50.63 miles, and 40.68 miles, respectively.[32] Therefore, the Company's claim that the SIR replaces 60 miles of steel infrastructure per year overstates the actual figures.

The record also shows that in 2005 and 2006, the Company's actual replacement rate was at a cost of $16.37 million and $16.16 million, respectively (Exh. DPU 1-09,

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31 The Company's average leak rate per mile from 1998 to 2003 was 2.31 times greater than the pre-merger period, the Company's pace of replacement during the rate freeze period was 2.5 times less than the pre-merger period. D.T.E. 05-27, at 42-43.

32 The Department acknowledges that the average rate of replacement is 50.19 miles per year, which is above the rate of 45.08 miles per year for the period prior to the rate freeze. The Department does not consider 50.19 miles per year to be an accelerated rate in light of the factors discussed in the text of Section VI.B.

Att. DPU 1-09 (Supp.) at 3). If the proposed \$4.04 million 2000-2003 average non-accelerated investment threshold were excluded, the net eligible capital additions to be included in the calculations of the proposed SIRC would be \$12.33 million and \$12.11 million for 2005 and 2006, respectively, excluding the costs of overhead and retirements (Exh. DPU-1-09, Att. DPU 1-09 (Supp.) at 3). Similarly, in 2007, the Company's total gross expenditures for its SIR program was \$15.20 million and the corresponding net eligible capital additions to be included in calculating the proposed SIRC would be \$11.16 million, excluding the costs overhead and retirements (Exh. DPU-1-09, Att. DPU 1-09 (Supp.) at 3). Therefore, the Company's claimed SIR expenditures of approximately \$20 million per year overstates the actual figures.

In addition to stating that the SIR was not accelerated in D.T.E. 05-27, the Department noted that the Company could be reasonably expected to resume its original pace of replacement that occurred prior to the rate freeze period of 1985 through 1998, 45.08 miles per year, without a base rate adjustment. D.T.E. 05-27, at 46-47. The record shows that, while the total miles of bare and unprotected coated steel mains replaced for 2005 is close to 60 miles per year, the totals for 2006 and 2007 are lower. Notably, the Company replaced 40.68 miles of bare and unprotected coated steel mains for 2007, which is less than the amount replaced by the Company prior to the merger five-year rate freeze period. This demonstrates that the pace of replacement under the SIR cannot be definitely defined as "accelerated" when compared to Bay State's pre-rate freeze replacement rate.

More importantly, the fact that the SIR costs and pace of replacement varies from year to year undermines any forecast based on expenditures and replacement pace provided in this proceeding. We cannot determine the future effect on the Company's financial condition because we do not know what will be accomplished in the future under the SIR and at what cost. This uncertainty is also tied to management's role in determining the appropriate pace of replacing its unprotected steel infrastructure in order to provide rate payers the greatest level of safety and reliability of service at the lowest possible price. D.T.E. 05-27, at 46.

In D.T.E. 05-27, the Department provided the Company, after five years from the date of issue of that Order, an opportunity to petition the Department for a one-time base rate adjustment arising solely from its steel replacement program, if the Company's ROE fell below six percent. Id. at 49-50. By including this provision, the Company was on notice that the SIR may affect its ROE at any point during the first five years of the PBR but could not seek recovery for the SIR until the mid-point. Even then, the Department limited the recovery to a one-time adjustment. The Department reviewed the SIR in this proceeding, two years into the PBR, based on the Company's claim of "extraordinary economic conditions." Given that the Department cannot find that extraordinary conditions exist, we cannot grant the Company recovery for the SIR.

In conclusion, we recognize that the Company is replacing steel infrastructure at a pace different than proposed in D.T.E. 05-27. The record, however, does not clearly support the Company's characterization that its program is accelerated and warrants granting it the requested relief. Therefore, we do not approve the Company's proposed SIR tariff. With this finding, we do not need to address such issues as the prudency of the replacement and replacement rate, the compatibility of SIR recovery within a PBR, the level of recovery already in base rates, and the specifics of calculating the annual SIR base rate adjustment mechanism identified by the parties.

VIII. OTHER MATTERS

Throughout this proceeding, in various ways, the Attorney General has objected to the limited scope of inquiry. Specifically, the Attorney General has said the following: (1) the Company must provide a full pro forma cost of service with revenues, rate base, operations and maintenance expenses, taxes, and return requirement with supporting expert testimony; (2) the Company's filing constituted a single issue rate case; and, (3) the Company's filing is not consistent with its PBR (Attorney General Brief at 19-24, 31; Attorney General Reply Brief at 3-10). Although many similar, if not identical, arguments were dealt with in D.P.U. 07-89, Interlocutory Order (April 18, 2008), for the sake of completeness, we will briefly discuss the Attorney General's remaining concerns in this section.

The Attorney General argues that without a full rate case, where all Company costs and revenues can be reviewed, the Department cannot approve new tariffs that increase Bay State's base rates (Attorney General Brief at 19-20). The Attorney General claims that, without this data, neither she nor the Department can evaluate the Company's need, financial condition, or the propriety of any rates that would go into effect (Attorney General Reply Brief at 3-7). In support of her position, the Attorney General relies on the Department's disfavor of single issue rate cases, which requires the review of one "cost in isolation" and the rule against retroactive ratemaking, which prohibits retroactive adjustments of base rates (Attorney General Brief at 14, 31).

The Department agrees that a full rate case pursuant to G.L. c. 164, § 94 is the preferred way to determine just and reasonable rates. Nonetheless, as we have recited in this Order, the Department does provide companies operating under a PBR the opportunity to obtain relief from the Department if circumstances warrant. See, e.g., D.T.E. 05-27, at 400. The manner in which a company seeks relief is within the discretion of the petitioning company. In fashioning a request for rate relief a petitioning company should be aware of our disfavor of single issue rate cases. Fitchburg Gas and Electric Light Company, D.T.E. 98-51, at 6, n.3 (1998) (it is the jurisdictional companies obligation to know Department ratemaking precedent).

In the present case, the Company made a filing under the terms of its PBR that permits a request for relief due to extraordinary economic circumstances. The Company chose to make a limited filing. We reviewed the Company's limited filing because it had made a prima facie case that it was in poor financial condition due to declining AUPC and its SIR. The Department's review in this case is consistent with the few times that we have reviewed changes to base rates in a limited proceeding. See, e.g., NSTAR Gas Company/Commonwealth Electric Company/Cambridge Electric Light Company/Boston Edison Company, D.T.E. 03-47-A at 16-19 (2003) (approval of pension adjustment mechanism); Cambridge Electric Light Company, D.P.U. 490, at 2-4 (1981) (approval of base rate increase to recover increased property tax expense). In this case, the Department finds that the evidence is inconclusive regarding (1) the Company's financial condition, (2) the level and duration of the decline in AUPC, and, (3) the need for a SIR tariff. Thus, the Department does not find that extraordinary economic circumstances exist to warrant the extraordinary measure of adjusting Bay State's rates in this limited proceeding. Therefore, the Department finds that the Attorney General's concerns have been made moot by our disposition of Bay State's petition.

IX. ORDER

Accordingly, after due notice, hearing and consideration, it is

ORDERED: That the tariffs M.D.P.U. 69 through M.D.P.U 94, filed by Bay State Gas Company on October 17, 2007, to become effective May 1, 2008, are DISALLOWED.

By Order of the Department,

/s/

Paul J. Hibbard, Chairman

/s/

W. Robert Keating, Commissioner

/s/

Tim Woolf, Commissioner

An appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. G.L. c. 5, 25.